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October 7, 2005

Honorable Mayor and City Council  
City of Midland  
Midland, Michigan

We are pleased to present the Comprehensive Annual Financial Report (CAFR) of the City of Midland for the fiscal year ended June 30, 2005. The City Charter and the Michigan Uniform Budgeting and Accounting Act require the City of Midland (the City) to prepare an annual financial report in accordance with accounting principles generally accepted in the United States (GAAP), and audited in accordance with generally accepted auditing standards. Accordingly, we hereby issue the CAFR of the City of Midland for the year ended June 30, 2005. This report was prepared in accordance with regulations and standards set forth by the City Charter, the Governmental Accounting Standards Board, the American Institute of Certified Public Accountants and its Committee on Governmental Accounting and Auditing, the Treasurer of the State of Michigan, and the Government Finance Officers Association.

This report consists of management's representations concerning the finances of the City. Management assumes full responsibility for the completeness and reliability of all of the information presented in this report. To provide a reasonable basis for making these representations, management has established a comprehensive internal control framework that is designed to protect the City's assets from loss, theft or misuse, and to compile sufficient reliable information for the preparation of financial statements in conformity with GAAP. Because the cost of internal controls should not outweigh their benefits, the City's comprehensive framework of internal controls has been designed to provide reasonable, rather than absolute, assurance that the financial statements will be free from material misstatement. To the best of our knowledge and belief, this financial report is complete and reliable in all material respects.

The City's financial statements have been audited by Plante & Moran, PLLC, a firm of licensed certified public accountants. The goal of the independent audit was to provide reasonable assurance that the financial statements of the City of Midland for the fiscal year ended June 30, 2005, are free from material misstatement. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the

overall financial statement presentation. The independent auditor concluded that there was a reasonable basis for rendering an unqualified opinion that the City's financial statements for the year ended June 30, 2005 are fairly presented in conformity with GAAP, and Governmental Auditing Standards issued by the Comptroller General of the United States. The independent auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the City was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports are presented separate from the CAFR.

GAAP require that management provide a narrative introduction, overview, and analysis to accompany the basic financial statements in the form of Management's Discussion and Analysis (MD&A). This letter of transmittal is designed to complement MD&A and should be read in conjunction with it. The City's MD&A can be found immediately following the report of the independent auditors.

## **Profile of the City**

The City of Midland was incorporated in 1887. Located near the center of the eastern portion of Michigan's lower peninsula, approximately 120 miles northwest of Detroit, the City currently occupies a land area of 35.7 square miles and, according to the 2000 Census, serves a population of 41,685. The City is empowered to levy a property tax on both real and personal properties located within its boundaries. It is also empowered to extend its corporate limits by annexation, which occurs periodically in accordance with state statute and the terms of urban cooperation agreements between the City and its surrounding townships.

The City Charter calls for a council-manager form of government. The governing body consists of five council members who are elected on a non-partisan basis, one from each of the City's five wards and who, in turn choose one of their number to serve as mayor. The City Manager and City Attorney are appointed independently by the City Council. The City Manager is responsible for carrying out the policies and ordinances of the City Council, for overseeing the day-to-day operations of the City and for appointing heads of the various departments and all other City employees. The City Attorney oversees all legal matters of the City, including review of contracts and legal documents.

The City provides a full range of services including police and fire protection, community planning and zoning, building inspections, code enforcement, library, sanitation, water and wastewater treatment, construction and maintenance of highways, streets and infrastructure, recreation programs, parks, public transportation and cultural facilities.

The annual budget serves as the foundation for the City's financial planning and control. In April of each year, the City Manager presents a proposed budget to the City Council for review. The Council holds public hearings and a final budget must be prepared and adopted no later than the fourth Monday in May. The Council approves appropriations on the functional basis, which is the legal level of control. Expenditures in excess of departmental appropriations are a violation of state law. Amounts not spent by the end of the fiscal year lapse, and require City Council approval to re-appropriate into the next year.

### **Assessing the City's Financial Condition**

The information presented in the financial statements is best understood when it is considered from the broader perspective of the environment in which the City operates:

Local economy: The economic environment of the City has remained steady, despite the difficult economic conditions that the State of Michigan and neighboring communities face. Historically, the City has been recognized as a community that offers its residents many economic, cultural, recreational, and educational benefits. Today these benefits remain as promising as ever, thanks in large part to the growth the area continues to experience. Much of past economic development has focused on the commercial and industrial sector's growth through The Dow Chemical Company and Dow Corning Corporation. While it is true that Dow and Dow Corning are still the major influences, with enough undeveloped land within their fences to expand further during the near term, there has also been an increased amount of time and attention spent on attracting and accommodating other firms. This emphasis upon diversifying the economic base reflects a broader development strategy, which is expected to continue during both the short and long term.

Tax base and/or employment in the City is also provided by a cogeneration power plant facility, small-to-medium manufacturing companies, retail and service establishments, a regional health care organization, state and local educational institutions, financial institutions and local government. The City's July 2005 unemployment rate of 4.8 percent compares favorably to the state's average rate of 7.6 percent and the national average of 5.2 percent. The employed labor force of 20,710 represents a decrease of approximately 5.6 percent from the previous year.

The largest single revenue source is property taxes. The City's tax base has shown steady growth historically, averaging 2.2% over the past five years. However, in recent years that growth rate has slowed, growing less than 1% in 2005. In 1997, the City's three largest taxpayers filed property assessment appeals, involving approximately 25% of the total tax base. One of these appeals was settled during the current fiscal year. The City is involved in vigorously defending the remaining two appeals before the Michigan Tax Tribunal. Cash reserves of approximately \$36 million, have been established to provide funding in the event that substantial refunds are awarded in either of these cases. The City's tax base is approximately 35% residential and 65% commercial, industrial and utility. The commercial, industrial and utility sector is comprised of administrative, research and production

facilities of two large chemical companies, a cogeneration power plant and a variety of other industries and businesses. The three largest industrial/utility taxpayers make up 50% of the tax base. The City Charter allows a property tax rate of up to 18 mills, which is then reduced by the Headlee Amendment to 17.87 mills. During the 2004-05 fiscal year, the City levied only 9.23 of its authorized mills. Under applicable state statutes, the City is also authorized to levy up to one additional mill for libraries and up to 3 additional mills for solid waste management.

In the past fiscal year, the state continued to experience economic difficulties. Approximately 11% of the City's total General Fund revenues come from sales tax that is collected by the state and shared with local units of government. Because of reductions in statewide collections of sales, income, and single business taxes, the state government has had fewer dollars to pass through to the local units, and has retained a higher portion of the sales tax, in order to balance its own budget. This resulted in a decrease in state shared revenue in the current year.

Long-term financial planning: The City maintains master plans for its streets, parks and water and sewer systems, and continues to actively improve infrastructure that supports its citizens. An annual inventory of street condition, aided by a computerized pavement management system, assists in planning current and future street maintenance and construction expenditures. Requests for infrastructure improvements are received from external and internal sources each year in November and are publicly evaluated and prioritized. The resulting engineering priorities report becomes an integral part of the annual budget process.

The City recently completed constructing \$2.5 million in storm sewer collection system improvements to address the only developed area of the City experiencing drainage deficiencies.

The City also recently completed constructing water distribution system improvements in order to increase water pressure within the northeast section of the City, where water pressure objectives of 45-60 pounds per square inch are not being consistently met, primarily because of higher land elevation in the area where additional residential and commercial growth is occurring. This project was substantially completed during the 2003-04 fiscal year at an estimated cost of \$2.5 million. The City's long-range financial plans for the Water Fund provides for system improvements to be financed out of operating revenues, without issuing additional debt.

In the fall of 2004 the City began construction of a new 107,000 civic arena. The new facility will include two NHL-size rinks, and one Olympic-size rink, will have twelve locker rooms and seat 1,000 people. The City issued \$6.5 million in bonds, and collected \$4.5 million in pledges from area foundations and ice enthusiasts to fund the construction of the facility.

Cash Management Policies and Practices: Cash temporarily idle during the year was invested, as authorized by the City's formal investment policy and Michigan Public Act 20 of 1943, as amended, in certificates of deposit, obligations of the U.S. Treasury, commercial paper, repurchase agreements and certain investment pools.

Maturities of the investments range from 30 days to eighteen months, with an average maturity of approximately 90 days. The pension trust fund portfolio also includes common stocks, corporate bonds, collateralized mortgage obligations and asset backed securities. The average yield on investments was 1.92% for the City and an average yield of 5.1% for the pension trust fund. Investment income includes appreciation in the fair value of investments. Changes in fair value during the current year, however, do not necessarily represent trends that will continue; nor is it always possible to realize such amounts, especially in the case of temporary changes in the fair value of investments that the City intends to hold to maturity.

Risk Management: The City is exposed to various risks of loss related to property loss, torts, errors and omissions and employee injuries. The City has purchased commercial insurance for all liability, property and employee health care exposures. Settled claims relating to this insurance have not exceeded the amount of insurance coverage in any of the past three fiscal years. The City's maximum deductible for property and liability exposures is \$50,000 per occurrence. For employee injury claims, the City participates in the Michigan Municipal Workers Compensation Pool, a common risk-sharing/management program for local units of government in Michigan. Member premiums are used to purchase commercial excess insurance coverage and to pay member claims in excess of deductible amounts.

Pension and Other Post-employment Benefits: The City sponsors a single-employer, defined-benefit pension plan for its police and fire employees. Each year, an independent actuary engaged by the pension plan calculates the amount of the annual contribution that the City must make to the pension plan to ensure that the plan will be able to fully meet its obligations to retired employees on a timely basis. As a matter of policy, the City fully funds each year's annual required contribution to the pension plan as determined by the actuary. As a result of the City's conservative funding policy, the City has succeeded as of December 31, 2004 in funding 96.4% of the present value of the projected benefits earned by employees. The remaining unfunded amount is being systematically amortized over 10 years as part of the annual required contribution calculation by the actuary.

The City also provides pension benefits that cover substantially all employees, other than police and fire employees. These benefits are provided through a state-wide plan managed by the Municipal Employees' Retirement System of Michigan (MERS). The City has no obligation in connection with employee benefits offered through this plan beyond its annual contractual payment to MERS.

The City also provides post-employment health care benefits for certain retirees and their dependents. As of the end of the current fiscal year, there were 301 retired employees receiving these benefits, which are financed on a prefunding basis. GAAP do not require governments to report a liability in the financial statements in connection with an employer's obligation to provide these benefits.

Additional information on the City's pension arrangements and post-employment benefits can be found in Notes 11 and 12 in the notes to the financial statements.

## Awards and Acknowledgements

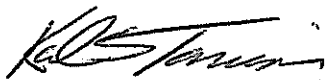
The Government Finance Officers Association (GFOA) of the United States and Canada awarded a Certificate of Achievement for Excellence in Financial Reporting to the City of Midland for its comprehensive annual financial report for the fiscal year ended June 30, 2004. This was the sixteenth consecutive year that the City has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report, which satisfies both GAAP and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

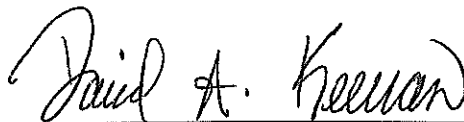
The preparation of this report was made possible by the dedicated service of the entire staff of the Finance Department, particularly that of Controller Margaret Maday, Assistant Controller Dana Strayer and Accountant Martha Rex. Each member of the Department has our sincere appreciation for the contributions made in the preparation of this report.

In closing, the preparation of this document and the accomplishments reported therein would not have been possible without the leadership and support of the Midland City Council.

Sincerely,



Karl S. Tomion  
City Manager



David A. Keenan  
Director of Fiscal Services